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No. 85-554

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a gambling casino using the accrual method of tax accounting is entitled to deduct, as a fixed liability at the close of its taxable year, the amounts registered on the "jackpot indicators" of its progressive slot machines, even though it has no obligation to pay such amounts unless and until the jackpots are won by its patrons in some future year.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is reported at 760 F.2d 1292. The opinion of the Claims Court (Pet. App. 5a-20a) is reported at 5 Cl. Ct. 641.

JURISDICTION

The judgment of the court of appeals (Pet. App. 4a) was entered on May 2, 1985. On July 11, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including September 29, 1985 (a Sunday). The petition was filed on September 30, 1985, and was granted on December 2, 1985. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 162, 446 and 461 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Section 1.461-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (Pet. App. 22a-24a).

STATEMENT

1. The relevant facts were stipulated (Pet. App. 5a). Respondent Hughes Properties, Inc., is a Nevada corporation that owns Harolds Club, a gambling casino in Reno, Nevada. During the tax years at issue, respondent owned and operated "progressive slot machines" in its casino (*id.* at 6a). Like other slot machines, a "progressive" slot machine pays fixed amounts when certain combinations of symbols appear. Unlike other slot machines, however, a "progressive" slot machine also has an additional, "progressive" jackpot. This jackpot is initially set at a minimum amount determined by the casino (*ibid.*). It automatically increases, according to a ratio determined by the casino, as money is gambled on the machine (J.A. 64). The amount of the jackpot outstanding at any given time is registered on a meter, or "payoff indicator," on the face of the machine (Pet. App. 6a-7a & n.2). This sum continues to increase as patrons gamble on the machine until the jackpot is won or until a maximum amount, again determined by the casino, is reached (*id.* at 6a). A progressive jackpot can be won only when a customer gambles the required amount of money and the machine displays the winning combination of symbols (*ibid.*).

The odds of winning a progressive jackpot are a function of the number of reels on the machine, the

number of positions on each reel where the reel may stop, and the number of winning symbols placed on each reel (Pet. App. 6a; J.A. 29). The odds are determined by respondent; provided that there actually exists a possibility that the winning combination of symbols can appear, respondent's discretion in setting odds is unrestricted. By adjusting the odds, respondent can determine, within limitations prescribed by the law of averages, the frequency with which any particular progressive slot machine will pay off. In a 1976 study of 24 representative machines, respondent ascertained that one machine had been in operation for 13 months without a payoff, that another machine had been in operation for 35 months without a payoff, and that the payoff frequency of the other 22 machines ranged from a high of 14.3 months to a low of 1.9 months (Pet. App. 7a n.1).

2. In September 1972 the Nevada Gaming Commission promulgated a rule that, for the first time, regulated the use of progressive slot machines by licensed casinos. Nev. Gaming Reg. § 5.110 (1972) (reprinted at J.A. 55-56). The rule requires gaming establishments to maintain daily records of the progressive jackpot amounts registered on each machine (Nev. Gaming Reg. § 5.110(5) (1972)). It directs that "[n]o payoff indicator shall be turned back to a lesser amount" unless the progressive jackpot is won by a customer, or unless "the change in the indicator reading is necessitated through a machine malfunction" (*id.* § 5.110(2)). In the latter event, a report explaining the reduction in the payoff indicator must be filed (*id.* § 5.110(5)). The rule does not address the consequences of a casino's election to discontinue use of a machine, *e.g.*, by retiring it from service or by removing it from the floor indefinitely. The Gam-

ing Commission's unwritten policy in such circumstances apparently is to require that the casino transfer the amount registered on the jackpot indicator of such a machine to another progressive slot machine remaining in play at the same premises. J.A. 78; see Nev. Gaming Reg. § 5.110(5) (1977) (reprinted at J.A. 56-57).

The Gaming Commission rule described above is strictly enforced by the Commission, which is authorized to impose sanctions (including license revocations) on casinos that wrongfully refuse to pay a progressive jackpot to a winning customer (Pet. App. 9a). The rule applies to all Nevada casinos so long as they remain in the gaming business (J.A. 44). If a casino were to go out of business, to surrender its gaming license, or to enter bankruptcy proceedings, it would no longer be subject to the rule and would be free to reduce or eliminate the amounts shown on its progressive jackpot indicators (*id.* at 23, 44). The rule does not address the treatment of progressive slot machine jackpots in the event of the sale or other disposition of a gaming business. The Gaming Commission's unwritten policy in such circumstances apparently is to require that the buyer continue the machines in play, without reduction of the payoff indicators (*id.* at 20, 38, 43, 59-60, 78). Whether the sales price would be adjusted to reflect that requirement, however, is a matter of negotiation between the buyer and the seller (*id.* at 20, 43, 59, 78).

It is respondent's practice to remove the coins deposited by customers into its progressive slot machines (generally called "the drop") at least twice per week and on the last day of each calendar month (J.A. 68). The Nevada Gaming Commission does not regulate respondent's use of the funds thus collected. The Commission's regulations were amended in 1977 to require that casinos at all times maintain either "a minimum cash reserve" or "sufficient cash or cash equivalents to provide payment of all progressive jackpots offered to the public as prizes" (Nev. Gaming Reg. § 5.110(3) (1977)). But casinos are free to invest such funds as they see fit until the jackpots are actually won by customers.

3. Respondent uses the accrual method of accounting for federal tax purposes. In compliance with the Gaming Commission rule described above, respondent recorded the meter readings shown on its progressive slot machines every day and made no impermissible reductions of the machines' payoff indicators (Pet. App. 9a). At midnight on the last day of its fiscal tax year, respondent entered the jackpot amounts shown on those indicators as an "accrued liability" on its books (*ibid.*). From that total, respondent subtracted the previous year's "accrued jackpot liability" to produce a "net accrued liability" for the tax year in question (*id.* at 10a). On its federal income tax returns for 1973-1977, respondent deducted the latter amounts under Section 162 of the Code[1] as "ordinary and necessary [business] expenses paid or incurred during the taxable year."

The Commissioner on audit disallowed the claimed deductions. He noted that, under the accrual method of tax accounting, an expense may not be deducted until "all of the events have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)). The Commissioner determined that the events which would fix respondent's liability to pay a particular progres-

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years at issue (the Code or I.R.C.).

sive jackpot would be some lucky patron's pull of the handle, and the consequent appearance of the winning symbols on the slot machine, in some future tax year. Until those events occurred, the Commissioner concluded, respondent's obligation to pay the jackpots was contingent and thus gave rise to no deductible expense (Pet. App. 10a). The Commissioner determined a deficiency in respondent's income tax in the amount of $433,000 for the tax years at issue (*id.* at 1a, 21a).

4. Respondent paid the asserted deficiency and, following the denial of its administrative claim for refund, filed this refund suit in the Claims Court. Respondent contended that the year-end amounts shown on the payoff indicators of its progressive slot machines were deductible because there was "a reasonable expectancy that * * * payment [would] be made" at some future date (J.A. 47). Respondent argued that the accrual of such amounts as current liabilities "conform[ed] with generally accepted accounting principles and result[ed] in a proper matching of revenues and expenses" (*id.* at 51). It produced an affidavit from its accountants to that effect (*id.* at 45-46, 69).

On cross motions for summary judgment, the Claims Court ruled for respondent (Pet. App. 4a, 19a). It concluded that, under the Gaming Commission rule described above, respondent's liability to pay the amounts on the progressive jackpot indicators became "unconditionally fixed" (*id.* at 14a) at "midnight of the last day of the fiscal year" (*id.* at 19a). In the Claims Court's view, the last event necessary to fix respondent's liability for the progressive jackpots was "the last play (successful or not) of the machine before the close of the fiscal year, that is,

the last change in the jackpot amount before the amount is recorded for accounting purposes" (*id.* at 13a). "The winning handle pull," the court said, would "only determine[] the fortunate gambler in whose favor the liability [would be] enforced" (*id.* at 14a) (original quotation marks omitted)). The court appeared to acknowledge that if respondent "were to close its doors and go out of business, * * * it would not owe the jackpots to anybody" (*id.* at 15a (original quotation marks omitted)). But "[e]ven if the progressive slot machines were to never pay off," the court reasoned, "the set jackpot amounts indicated on the face of the machine[s] would still continue to be an *incurred* liability fixed by state law" (*id.* at 14a (emphasis in original)). The court said that a contrary result would mismatch respondent's income and expenses and in effect would "convert [respondent] * * * from an accrual basis taxpayer to a cash basis taxpayer" (*id.* at 14a-15a (emphasis omitted)).

The Federal Circuit affirmed "on the basis of the * * * Claims Court opinion" (Pet. App. 3a). It held that a "fixed liability" exists for federal tax purposes "if there is an obligation to perform an act and the cost of performance can be measured in money" (*id.* at 2a). Applying that standard, it agreed with the Claims Court that respondent's progressive-jackpot liability was "unconditionally fixed as of the close of the taxable year" (*ibid.*). The court noted that its holding conflicted with that of the Ninth Circuit in *Nightingale* v. *United States*, 684 F.2d 611 (1982), but it did not further discuss that decision or the reasoning that the Ninth Circuit there advanced.

SUMMARY OF ARGUMENT

The timing of deductions for accrual-basis taxpayers is governed by the "all events" test of tax accounting. That test has two elements, both of which must be satisfied before accrual of an expense is proper. First, "all of the events [must] have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)). Second, "the amount [of the liability must] be determin[able] with reasonable accuracy" (*ibid.*). The question here is whether respondent met the first part of the test, that is, whether it had a "fixed liability" to pay the progressive jackpots as of the close of its tax year.

This Court has consistently held that a liability does not accrue for purposes of the "all events" test as long as it remains contingent. *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). To be deductible for tax purposes, "the obligation to pay [must] ha[ve] become final and definite." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 287 (1944). It must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930).

Respondent's liability for the progressive slot machine jackpots was plainly not "fixed" or "unconditional" at midnight on the last day of its tax year. At that moment, there existed no person at all who could assert any possible claim to those funds. Rather, respondent's liability to pay each jackpot was contingent upon a future event—some lucky patron's winning pull of the slot machine handle at an indeterminate future time. Until that event happened, "all the events" that were necessary to make respondent's liability fixed and unconditional had not occurred. Respondent quite simply was not liable to anyone until somebody won the jackpot.

Contrary to the court of appeals' statement, the Nevada Gaming Commission rule, which prohibits casinos from turning back the meters on their progressive slot machines, does not alter the conditional nature of respondent's year-end liability. That rule does not require respondent to pay a jackpot unless and until it is won by a customer. The rule thus leaves respondent's year-end liability subject to the same future condition—the winning pull of the handle—to which it was subject before the rule was promulgated. The effect of the rule is simply to place a floor beneath the *amount* of respondent's *potential* liability: it dictates that the dollar amount of respondent's obligation, if and when it is incurred, will be at least a specified sum. But while the Gaming Commission rule might thus be relevant in deciding whether the amount of respondent's liability could "be determined with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)) for purposes of the *second* part of the "all events" test, that rule makes no difference in deciding whether respondent's liability, for purposes of the first part of the test, is "fixed" and "unconditional" at year's end.

In permitting respondent to take a current tax deduction for a contingent future expense, the court of appeals ignored the import of this Court's decisions emphasizing the critical differences between tax and financial accounting. Because there is a probability that respondent will eventually incur liability for its progressive jackpots, financial accounting rules, implementing "the principle of conservatism" (*Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542 (1979)), may well require respondent to establish a year-end reserve for those items and show them as a liability on its books. But "[o]nly a few

reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts" (*Brown* v. *Helvering*, 291 U.S. at 201-202). Rather, "the tax law requires that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain" (*Thor Power Tool Co.*, 439 U.S. at 543, quoting *United States* v. *Anderson*, 269 U.S. 422, 441 (1926)). By insisting upon certainty of liability rather than probability, the "all events" test serves the objective of tax accounting "to protect the public fisc" (*Thor Power Tool Co.*, 439 U.S. at 542) by ensuring that taxpayers do not obtain current tax deductions for contingent expenditures that may actually occur far in the future, or not at all.

ARGUMENT

THE AMOUNTS SHOWN ON THE JACKPOT INDICATORS OF RESPONDENT'S PROGRESSIVE SLOT MACHINES WERE NOT DEDUCTIBLE AS AN ACCRUED EXPENSE AT THE CLOSE OF ITS TAXABLE YEAR

A. An Expense Is Not Deductible For Federal Tax Purposes Until There Exists A Fixed Liability To Pay It, And Respondent Had No Obligation To Pay The Jackpots Unless And Until Somebody Won Them

1. Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A taxpayer who uses the "cash receipts and disbursements method" of accounting (I.R.C. § 446(c)(1)) is entitled to deduct business expenses only in the year in which they are paid (Treas. Reg. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1)). A taxpayer who uses the

"accrual method" of accounting (I.R.C. § 446(c)(2)), by contrast, is entitled to deduct expenses in the year in which they are "incurred," regardless of when they are actually paid (I.R.C. § 162(a); Treas. Reg. § 1.461-1(a)(2)). It is well settled that " 'to incur' means to become liable or subject to." *Ox Fibre Brush Co.* v. *Blair*, 32 F.2d 42, 47 (4th Cir. 1929), aff'd *sub nom. Lucas* v. *Ox Fibre Brush Co.*, 281 U.S. 115 (1930). "[A] thing for which there exists no obligation to pay, either express or implied, cannot in law be claimed to constitute an 'expense incurred.' " *United States* v. *St. Paul Mercury Indemnity Co.*, 238 F.2d 594, 598 (8th Cir. 1956).

For almost sixty years, the standard for determining when an item of expense is to be regarded as "incurred" for federal tax purposes has been the "all events" test. That test was first enunciated by this Court in *United States* v. *Anderson*, 269 U.S. 422 (1926), where it was held that an expense is deductible, not for the year in which an obligation attaches "[i]n a technical legal sense," but for the year in which "all the events [have] occur[red] which fix [its] amount * * * and determine the liability of the taxpayer to pay it" (269 U.S. at 441). The "all events" test has subsequently been incorporated in the Treasury Regulations. See Treas. Reg. §§ 1.446-1(c)(1)(ii) (accruals in general), 1.451-1(a) (accrual of income), 1.461-1(a)(2) (accrual of deductions). The Court has described it as "a fundamental principle of tax accounting" and as "the 'touchstone' for determining the year in which an item of deduction accrues." *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 385 (1961).

The "all events" test has two elements, both of which must be satisfied before accrual of an expense

is proper. First, "all the events [must] have occurred which establish the fact of the liability giving rise to [the] deduction" (Treas. Reg. § 1.446-1(c)(1)(ii)). Second, the amount of the deduction must be capable of being "determined with reasonable accuracy" (*ibid.*). The second part of the test permits a degree of computational flexibility. See *Lucas* v. *American Code Co.*, 280 U.S. 445, 450 (1930); Treas. Reg. § 1.461-1(a)(2). But the Regulations emphasize that the first part of the test is absolute: "no accrual shall be made in any case [unless] all of the events have * * * occurred which fix the liability" (*ibid.*).

In determining whether a liability has become "fixed," and thus constitutes an "expense incurred during the taxable year" for federal tax purposes, this Court long ago made clear that "a liability does not accrue as long as it remains contingent." *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). Accord, *e.g.*, *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, 519 (1944). "The prudent businessman," Justice Brandeis wrote for the Court, "often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co.*, 280 U.S. at 452 (footnote omitted). Accord, *Brown* v. *Helvering*, 291 U.S. at 201-202; *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 269 (1930). To be deductible for federal tax purposes, "the obligation to pay [must] ha[ve] become final and definite." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 287 (1944). It must be "fixed and absolute." *Brown* v. *Helvering*, 291 U.S. at 201. It must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930). "[T]he tax law requires," in short, "that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 543 (1979) (quoting *United States* v. *Anderson*, 269 U.S. at 441).

2. Contrary to the statements of the courts below (Pet. App. 2a, 14a), respondent's liability for the progressive slot machine jackpots was not "fixed and certain," was plainly not "unconditional" or "absolute," at midnight on the last day of its fiscal tax year. At that moment, there existed no person at all who could assert any possible claim to those funds. An expense may not be deducted consistently with this Court's decisions until *all the events* have occurred that *unconditionally establish* the fact of the taxpayer's liability. In the case of a progressive slot machine liability, "[t]he one, indispensable such event is the winning of the progressive jackpot by some fortunate gambler. Until that event occurs, no actual liability has been incurred." *Nightingale* v. *United States*, 684 F.2d at 614. Because "the casino's liability on each slot machine is contingent * * * * * upon a winning pull" of the slot machine handle, that event, as the Ninth Circuit has correctly held, is "most naturally regarded as a condition precedent" to the creation of a fixed obligation (*id.* at 614, 615).

Since the progressive jackpots had not been won at the close of respondent's fiscal year, respondent as of then had incurred no liability, much less a fixed and unconditional liability, to pay those sums to anyone. It was of course likely that respondent would *eventually* incur a liability to pay those amounts, since it was probable (given the law of averages) that some lucky customer would eventually pay his money and hit the winning combination of symbols. But Nevada law places "no restrictions * * * on

gaming establishments for the setting of odds, provided that there is actually a possibility that the winning combination of symbols can appear" (*Nightingale* v. *United States*, 684 F.2d at 612). Respondent thus had discretion, subject to the law of averages, to defer indefinitely into the future the time at which its liability would be incurred. The odds of winning a progressive jackpot at the casino involved in *Nightingale* in fact varied "from one chance in 8,000 to one chance in 9,765,625" (*ibid.*). Nevada law, moreover, places "no restrictions on the transferability of the accrued but unpaid [jackpot amounts] on one progressive slot machine to another progressive slot machine." *Id.* at 613. See J.A. 78; Nev. Gaming Reg. § 5.110(5) (1977). Respondent thus had discretion, again subject to the law of averages, to advance ever further into the future the time at which its liability would be incurred, simply by removing a machine from the floor and transferring the amount shown on its jackpot meter to another machine with a more distant projected payoff date.

Besides being able indefinitely to defer the date of actual liability, respondent also had discretion to avoid incurring any liability at all. "If [a casino] were to close its doors and go out of business," the Ninth Circuit observed in *Nightingale*, "it would not owe the jackpots to anybody," a fact that "tends to show that there is no present liability" (684 F.2d at 615). The record in this case likewise reveals that if respondent were to sell its business, cease its gaming operations, or enter bankruptcy, or if its patrons were to stop playing its slot machines, it would have no liability, and would never have any liability, to pay the jackpots to anyone. See J.A. 20,

23, 43-44, 59, 78. It may well be, as respondent's witness stated below (*id.* at 63), that the possibility of these things happening was "extremely remote and speculative." But the odds of their happening, like the odds of a customer's winning a progressive jackpot, were entirely a matter of respondent's discretion. And there is no reason to believe that the odds against their happening, mathematically speaking, differed appreciably from the odds against a customer's winning the jackpot on a progressive slot machine programmed to pay off (say) at "one chance in 9,765,625" (*Nightingale*, 684 F.2d at 612).

3. In permitting respondent to take a current tax deduction for progressive jackpots that nobody had yet won, the courts below relied principally on the Nevada Gaming Commission's regulations. As we have noted, Section 5.110(2) of those rules, adopted in 1972, provides that "[n]o payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player" (J.A. 55). "Th[is] [C]ommission regulation," the court of appeals said, "makes the guaranteed jackpot a fixed liability" (Pet. App. 2a). The Claims Court similarly reasoned that, "[e]ven if the progressive slot machines were to never pay off, the set jackpot amounts indicated on the face of the machine[s] would still continue to be an incurred liability fixed by state law" (*id.* at 14a (emphasis omitted)).

This reasoning is seriously flawed. The Gaming Commission rule does not require respondent to pay a jackpot unless and until it is won by a customer. The rule thus leaves respondent's year-end liability in essentially the same contingent state that it was in, and leaves it subject to exactly the same condi-

tion (the winning pull of the handle) to which it was subject, before the Gaming Commission began regulating progressive slot machines in 1972. The effect of the rule is simply to place a floor beneath the *amount* of respondent's *potential* liability, while leaving the liability itself contingent. By prohibiting casinos from turning back the jackpot indicators, the rule ensures that those meters at all times will indicate the minimum amount that a future patron will win if he hits the winning combination of symbols. The rule provides that the dollar amount of the jackpot respondent offers can never ratchet down, but must always stay the same or ratchet up; it dictates that respondent's liability, if and when it is incurred, will be in an amount proportional to the number of times the machine has previously been played. But because the rule does not require respondent to pay a jackpot unless and until it is actually won, the rule does not alter the contingent nature of respondent's obligation at the close of its tax year.

Of course, if respondent *did* have a fixed rather than a contingent liability at the close of its tax year, the Gaming Commission rule could well permit respondent to satisfy the *second* part of the "all events" test. Given the existence of that rule, arguably, it would be possible for "the amount [of respondent's liability to] be determined with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)). Respondent, however, did not have an unconditional liability at that time, and the Gaming Commission rule makes no difference in determining whether this first, and essential, component of the "all events" test has been satisfied.

4. The Claims Court sought to support its result by reasoning that, "were the actual winning handle pull held to be the last event necessary to satisfy the 'all events' test, the effect * * * would be to convert [respondent] from an *accrual* basis taxpayer to a *cash* basis taxpayer" (Pet. App. 14a-15a (emphasis in original)). This argument, which respondent repeats (Br. in Opp. 5, 13), is both factually erroneous and legally irrelevant. The event that converts respondent's offer of a jackpot from a contingent to a fixed liability, and which thus justifies an accrual under the "all events" test, is the winning pull of the slot machine handle. Because the money corresponding to the jackpots will typically be sitting in the casino's bank account rather than in the slot machine (see pages 4-5, *supra*), the customer's winning pull of the handle and his receipt of payment from the casino will not normally be contemporaneous. Once a jackpot has been won, however, the casino may properly claim a deduction, consistently with its accrual method of accounting, regardless of whether it writes its customer a check for his winnings at once or defers payment until the next day or the next year.[2] Respondent's assertion that our position effectively puts it on the cash basis of accounting for progressive jackpots is thus incorrect.

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[2] The sole exception would be where the casino contested its liability. See, *e.g.*, *Dixie Pine Co.* v. *Commissioner*, 320 U.S. at 519 (all the events necessary to fix a taxpayer's liability have not occurred where "the liability is contingent and is contested by the taxpayer"); J.A. 77 (Nevada gaming authorities will dismiss a complaint alleging nonpayment of a progressive jackpot upon determining that "the gaming establishment justifiably refused to pay the progressive jackpot because of cheating by the customer or other valid reasons.").

Even if respondent's assertion were factually correct, however, it would be irrelevant to the outcome. Under the "all events" test, an expense may not be deducted until the taxpayer has incurred a fixed liability to pay it. A taxpayer that elected, for reasons adequate to itself, to incur and to discharge its liabilities simultaneously could not be heard to complain that the "all events" test had the effect of requiring it "to report [those] expenses on the cash method" (Br. in Opp. 13).

5. While the facts of this case may seem exotic, they are a variation on a theme that recurs frequently in tax jurisprudence. It often happens that a taxpayer is under a present obligation—be it statutory, regulatory, or contractual—to make specified future payments upon the happening of specified future events. This Court and the lower courts alike have held that such generalized and incomplete obligations cannot justify current tax deductions under the "all events" test, correctly reasoning that such liabilities remain contingent until the requisite future events have transpired. These decisions show the error of the court of appeals' notion that a deduction is allowable for federal tax purposes, without more, "if there is an obligation to perform an act and the cost of performance can be measured in money" (Pet. App. 2a).

This Court's decision in *Brown* v. *Helvering*, *supra*, is particularly instructive. The taxpayer there was an insurance agent who received "overriding commissions" on the sale of insurance policies (291 U.S. at 195). "As to each such commission there arose the obligation—a contingent liability—to return a proportionate part in case of cancellation" (*id.* at 199). The taxpayer established on his books a reserve ac-

count in which he recorded, at year's end, "an estimate of the liability expected to arise out of [his] obligations to refund [part of the commissions] because of cancellations which it was expected would occur in future years" (*id.* at 197). Based on past experience, the taxpayer was able to predict with reasonable accuracy the percentage of policies that would be cancelled, and thereby to calculate with colorable precision the portion of the commissions that he would ultimately be required to return (*id.* at 197-198, 201 & n.7). The taxpayer sought to deduct, as a business expense "incurred during the taxable year," the amount added annually to this reserve (*id.* at 200).

This Court unanimously sustained (291 U.S. at 200) the Commissioner's disallowance of the claimed deduction:

> It is true that where a liability has "accrued during the taxable year" it may be treated as an expense incurred; and hence as the basis for a deduction, although payment is not presently due, * * * and although the amount of the liability has not been definitely ascertained. *United States* v. *Anderson*, [269 U.S. at 441]. * * * But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent.

The Court acknowledged that there existed "a strong probability," judging from the taxpayer's past experience, that many of the policies written during the year would be cancelled (291 U.S. at 201). "But experience taught also," the Court wrote, "that we are

not dealing here with certainties." Because the taxpayer's "liability * * * arising from expected future cancellations * * * was not fixed and absolute" at the close of his tax year (*ibid.*), the deduction that he sought was denied.

The lower courts have reached similar results in a variety of factual settings. In *Trinity Construction Co.* v. *United States*, 424 F.2d 302 (5th Cir. 1970), an employer had a contractual obligation to pay future premiums on policies insuring the lives of key employees, and it sought a current deduction for the premium payments expected to be made over the contract term. The Fifth Circuit denied a deduction; it noted that the employer's liability was contingent on the employees' being alive when the premiums were due, and it held that an expense may be deducted "only in the taxable year when the obligation to pay it is unconditionally fixed" (424 F.2d at 305). In *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450 (8th Cir. 1983), an employer had a contractual obligation to make future payments to a profit-sharing plan on account of employees' past services, provided that the individuals were still employed when the payments were due. The Eighth Circuit denied a current deduction; it noted that "the forfeiture provision made the * * * liability a contingent liability," and it held that a "liability is not fixed until all the conditions for payment are met" (699 F.2d at 453). In *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786 (1974), aff'd, 564 F.2d 886 (9th Cir. 1977), an airline had a contractual obligation to make future payments for statutorily-required engine overhauls, and it sought a current deduction for amounts expected to be paid over the contract term. The Tax Court denied a deduction; it noted that the taxpayer "was

under no obligation to make any payment unless an overhaul was actually performed," and it held that an expense is not deductible unless the taxpayer's liability is "absolutely fixed in the year of accrual" (62 T.C. at 802, 804).

The rationale of these cases shows the error of the holding below. Respondent's obligation was in the nature of the offer of a prize, a prize that might be won if and when some future patron paid his money and plucked the winning combination of stars, bars, and fruit. So long as respondent chose to stay in the gambling business, the Gaming Commission's rule required that this offer be irrevocable. But respondent's *liability* on the offer was nevertheless contingent until a future customer *accepted* the offer by satisfying the preconditions for payment. One does not have an "unconditional liability" unless there exists some person or entity to whom he is liable, and respondent was not liable to anyone until somebody won the jackpot.

B. In Permitting Respondent To Take A Current Tax Deduction For A Contingent Future Expense, The Court Of Appeals Misapprehended The Differences That This Court Has Recognized Between Tax And Financial Accounting

Following the promulgation of the Gaming Commission's rule in 1972, respondent's accountants determined that there thenceforth existed a sufficient likelihood that respondent's jackpots would be paid to require that the year-end amounts shown on its payoff indicators "be reported on the financial records of the corporation as accrued liabilities" (J.A. 68, 69). The accountants explained that this treatment was required in order properly to match respondent's expenses with its income. "Because the amount of the

liability for accrued but unpaid * * * jackpots increases in direct proportion to the volume of play on the machines, and because the income is recorded during the same period in which the play occurs * * *, the recordation of the increase in the accrued but unpaid * * * jackpots as a reduction of the slot machine gross profit in the same period results in a proper matching of revenues and expenses and clearly reflects income" (*id.* at 68). The accountants testified that this treatment "conform[ed] with generally accepted accounting principles" and that any other treatment "could result in a material distortion of [respondent's] income" (*id.* at 69).

The court of appeals appeared to find these statements persuasive in permitting a corresponding deduction for tax purposes. It reasoned that "the accounting method used by [respondent] results in allocation of the expense to the year in which the revenues were earned," and so concluded that respondent's "method of accounting accurately reflects the casino's income and expenses" (Pet. App. 2a-3a). "If we were to require that the deduction of a jackpot liability be deferred" until the jackpot was actually won, the court of appeals said, it would mismatch respondent's revenue and expenses and thus "distort taxable income for the year of payment" (*id.* at 2a).

In thus reasoning, the Federal Circuit ignored the import of this Court's decisions emphasizing the critical differences between tax and financial accounting. The court of appeals' misapplication of the "all events" test seems largely traceable to its neglect of this distinction, a distinction that is crucial to a proper understanding of the role that the "all events" test plays in the tax law.

1. Taxable income is generally computed "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" (I.R.C. § 446(a)). Section 446(b), however, sets forth an exception to this rule, providing that, if the method of accounting used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." The Regulations provide that "[t]he term 'method of accounting' includes not only the overall method of accounting of the taxpayer," such as the cash method or the accrual method, "but also the accounting treatment of any item." Treas. Reg. § 1.446-1(a)(1). The Regulations categorically state that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." Treas. Reg. § 1.446-1(a)(2).

Section 446 and its accompanying regulations obviously vest the Commissioner with "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959). This Court early noted that the general rule permitting use of the taxpayer's usual accounting practice "is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income." *Lucas* v. *American Code Co.*, 280 U.S. at 449. And the Court recently reaffirmed that the Commissioner in the accounting area has " '[m]uch latitude for discretion' " and that "his interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.' " *Thor Power Tool Co.*, 439 U.S. at 532 (quoting *Lucas* v. *American Code Co.*, 280 U.S. at 449). Accord, *e.g.*, *United States* v.

Catto, 384 U.S. 102, 114 (1966); *Schlude* v. *Commissioner*, 372 U.S. 128, 133-134 (1963); *American Automobile Ass'n* v. *United States*, 367 U.S. 687, 697-698 (1961); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 189-190 (1957); *Brown* v. *Helvering*, 291 U.S. at 203.

Congress's decision to grant the Commissioner "broad powers" to depart from the taxpayer's usual accounting practice in computing taxable income owes in part to "the vastly different objectives that financial and tax accounting have." *Thor Power Tool Co.*, 439 U.S. at 542. "The primary goal of financial accounting is to provide useful information to management, shareholders, [and] creditors" and "to protect these parties from being misled" (*ibid.*). Financial accounting accordingly "has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income" (*ibid.*; original quotation marks omitted). "[T]he major responsibility of the Internal Revenue Service," by contrast, "is to protect the public fisc," so that "understatement of income is not destined to be its guiding light" (*ibid.*). Given this diversity, even contrariety, of objectives, to say that a taxpayer's accounting practice " 'is in accord with generally accepted commercial accounting principles' * * * is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *American Automobile Ass'n* v. *United States*, 367 U.S. at 693 (footnote omitted).

This Court's cases demonstrate that divergence between tax and financial accounting is especially common where, as here, "a taxpayer seeks a current deduction for estimated future expenses or losses"

(*Thor Power Tool Co.*, 439 U.S. at 541). Financial accounting rules, implementing the principle of conservatism, "typically require that a liability be accrued as soon as it can reasonably be estimated" (*id.* at 543 & n.20 (citing authorities)). Accruals of such anticipated liabilities are commonly made by establishing on the corporation's books a reserve account to cover amounts reasonably expected to be paid in the future. See, *e.g.*, *Commissioner* v. *Hansen*, 360 U.S. at 448 (reserve to cover contingent liability in event of nonperformance of guarantee); *Brown* v. *Helvering*, 291 U.S. at 196-197 (reserve to cover expected liability in event of insurance policy cancellations); *Lucas* v. *American Code Co.*, 280 U.S. at 447 (reserve to cover contingent liability on contested lawsuit).

But while "[t]he prudent businessman often sets up reserves to cover contingent liabilities[,] * * * they are not allowable as deductions" (*Lucas* v. *American Code Co.*, 280 U.S. at 452). Rather, "the tax law requires that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain" (*Thor Power Tool Co.*, 439 U.S. at 543 (quoting *United States* v. *Anderson*, 269 U.S. at 441)). "[T]he 'all events' test * * * is designed to assure that taxpayers will not obtain deductions for expenditures that might never occur," and it thus "seeks certainty of liability rather than probability" (*World Airways, Inc.*, 62 T.C. at 805 (citing *Brown* v. *Helvering*, 291 U.S. at 201)). By insisting upon certainty of liability, the "all events" test helps guarantee that taxable income will be computed in a manner that "clearly reflect[s] income" (I.R.C. § 446(b)), for "[i]t has long been held that in order truly to reflect the income of a given year, all the events must

occur in that year which fix the amount and the fact of the taxpayer's liability" (*Dixie Pine Co.* v. *Commissioner*, 320 U.S. at 519).

2. The court of appeals departed from these well-established principles in sustaining respondent's deduction. It may well be, as respondent contended below, that the year-end accrual of its contingent slot machine liabilities "conform[ed] with generally accepted accounting principles" (J.A. 69) because there was "a reasonable expectancy that * * * payment [would] be made" (*id.* at 47). There was surely a probability, gambling being what it is, that respondent would eventually incur liability for its progressive slot machine jackpots. Although the timing of that liability's incurrence was subject to respondent's discretion in setting odds, there was also a mathematical possibility that it might be incurred the very next day. Thus, "the principle of conservatism" (*Thor Powe. Tool Co.*, 439 U.S. at 542) may well have required respondent to set up a reserve for those items at once and show them as a liability on its books. "[B]ut the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes" (*id.* at 543). Although "estimates, probabilities, and reasonable certainties * * * may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health," the tax law, "with its mandate to preserve the revenue, can give no quarter to uncertainty" (*ibid.*). "Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts." *Brown* v. *Helvering*, 291 U.S. at 201-202 (quoted in *Thor Power Tool Co.*, 439 U.S. at

543-544). A reserve for contingent slot machine liabilities is not among those so authorized.[3]

Contrary to the court of appeals' statement, therefore, the fact that respondent's method of accounting arguably "results in allocation of the expense to the year in which the revenues were earned" (Pet. App. 3a) does not control the outcome here. In *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961), this Court held that "a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of 'generally accepted commercial accounting principles'" (*Thor Power Tool Co.*, 439 U.S. at 541 (quoting *American Automobile Ass'n*, 367 U.S. at 690)). The Court acknowledged that the taxpayer's accounting method, by taking prepaid dues into income ratably over the future years during which it would render the paid-for services, "doubtless presents a rather accurate image of the total financial structure" (367 U.S. at 692). Put the Court nonetheless held that the taxpayer's reserve method "fail[ed] to respect the criteria of annual tax accounting and [could] be rejected by the Commissioner" (*ibid.*).

The same reasoning applies in the present case. By establishing a reserve for its progressive jackpot liabilities, and by making additions to that reserve ratably with its realization of slot machine income, respondent may well have produced an accurate matching of its revenues and expenses for purposes of financial accounting. But that fact provides no

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[3] Cf. I.R.C. § 166(c) (authorizing bad debt reserves in general); I.R.C. §§ 585, 586, 593 (authorizing bad debt reserves for banks and S & L associations); I.R.C. § 807 (authorizing specialized reserves for life insurance companies).

basis for permitting respondent currently to deduct those contingent liabilities on its federal tax return.

3. As this Court noted in *American Automobile Ass'n*, 367 U.S. at 694-697, Congress once adopted, albeit only briefly, provisions that would have permitted taxpayers to deduct anticipated expenses by a reserve mechanism similar to that used by respondent. As originally enacted in 1954, Section 462 of the Code allowed a deduction for "a reasonable addition to [a] reserve for estimated expenses," with "estimated expenses" being defined to include deductions "attributable to the income of the taxable year or prior taxable years." Internal Revenue Code of 1954, § 462(a) and (d)(1)(B), 68A Stat. 158-159. Section 452 as originally enacted similarly permitted accrual-basis taxpayers to defer recognition of prepaid income until later years in which the income was deemed "earned." *Id.* § 452(a), 68A Stat. 152. Congress was moved to enact these provisions by dissatisfaction with the fact that, "as a result of court decisions and rulings, there ha[d] developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles." H.R. Rep. 1337, 83d Cong., 2d Sess. 48 (1954). See *American Automobile Ass'n*, 367 U.S. at 694. Sections 452 and 462 were designed to bring "[t]ax accounting * * * more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." S. Rep. 372, 84th Cong., 1st Sess. 3 (1955). See *American Automobile Ass'n*, 367 U.S. at 703-704 (Stewart, J., dissenting).

The change brought about by Sections 452 and 462 was short-lived. Congress repealed those provisions retroactively less than one year later, prompted by warnings from the Treasury Department "that the proposed endorsement of such [methods of] accounting would have a disastrous impact on the Government's revenue." *American Automobile Ass'n*, 367 U.S. at 695. See Act of June 15, 1955, ch. 143, §§ 1, 3, 69 Stat. 134-135 (repealing 26 U.S.C. (1952 ed. & Supp. II 1954) 452, 462); H.R. Rep. 293, 84th Cong., 1st Sess. 3 (1955) (noting increase in the Treasury's projection of estimated revenue loss from $47 million to $1 billion). The taxpayer in *American Automobile Ass'n* contended that Congress's retroactive repeal of these provisions should not be interpreted to preclude use of the reserve method of tax accounting that it employed, but the Court held that this contention "'varnish[ed] nonsense with the charm of sound'" (367 U.S. at 695). "[T]he cold fact," the Court said, "is that [Congress] repealed the only law incontestably permitting the practice upon which the [taxpayer] depends" (*ibid.*).

Congress thus has specifically considered and, upon reconsideration, rescinded a provision that would have achieved the very result that the court of appeals here adopted. By discarding the "all events" test, the now-repealed Section 462 was designed to bring tax accounting into line with "generally accepted accounting principles which require all determinable liabilities relating to reported income to be taken into account" (S. Rep. 1622, 83d Cong., 2d Sess. 63 (1954)). The court of appeals had no license, by misapplying the "all events" test, to resurrect the rule that Congress deliberately discarded.[4]

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[4] Congress more recently has amended the Code to clarify the requirements for accrual of certain deductions, providing that

4. In sustaining respondent's claimed deductions, the court of appeals also ignored this Court's warning about "the well-known potential for tax avoidance" (*Thor Power Tool Co.*, 439 U.S. at 538) in-

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expenses generally may not be accrued until "economic performance" has occurred. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601 (adding I.R.C. § 461(h) and (i)). Congress set forth for the first time a statutory definition of the "all events" test, providing that "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy" (I.R.C. § 461(h)(4)). This definition, of course, is the same as that previously enunciated by this Court and by the Treasury Regulations. See page 12, *supra*. The 1984 Act generally provides that, "in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs" (I.R.C. § 461(h)(1)). Where the taxpayer's liability arises from the provision of goods or services, or from the use of property, "economic performance" is generally deemed to occur when the goods or services are actually provided, or when the property is actually used (I.R.C. § 461(h)(2)(A) and (B)). Where the taxpayer's liability arises from a worker's compensation statute or tort, "economic performance" is deemed to occur when payments to the recipient are actually made (I.R.C. § 461(h)(2)(C)). An exception from the general rule is made for "certain recurring items" (I.R.C. § 461(h)(3)). Such items may be deducted in the year preceding economic performance, provided that the "all events" test is otherwise satisfied, that economic performance actually occurs within a "reasonable period" (typically, 8½ months) after the close of the tax year, and that such accrual is consistent with financial accounting practices (I.R.C. § 461(h)(3)(A) and (B)). These provisions, which are generally effective for post-1983 tax years (Pub. L. No. 98-369, § 91(g), 98 Stat. 608), have no application to the instant case, which involves respondent's tax liabilities for 1973-1977.

herent in accounting techniques of the sort involved here. Respondent is unquestionably entitled to deduct its progressive slot machine liabilities if and when the jackpots are won by its customers. The dispute here, as in "all events" cases generally, concerns the proper *timing* of deductions, not the intrinsic propriety of the deductions themselves. But to suggest, as respondent seems to do (Br. in Opp. 4, 11-12), that this consideration diminishes the importance of the dispute is to ignore the time value of money. A deduction today is worth more than a deduction one, five, or twenty years from now. If the accruals involved are sufficiently large, their time value alone, as this case demonstrates (Pet. App. 1a, 21a), can involve huge amounts of revenue.

When respondent's customers gamble unsuccessfully on its progressive slot machines, the monies lost represent income that is subject at once to respondent's use and enjoyment. Although respondent will in all probability be required ultimately to return a portion of those funds as jackpots to its customers, it is free to invest the money, and to earn additional income upon it, until the jackpots are actually won. The time at which the jackpots will actually be won, and how large they will be at that time, are essentially within respondent's control. It has discretion to determine when a machine will be placed in service, what the initial jackpot will be, and by what rate that amount will progress. Given its virtually unrestricted discretion in setting odds, respondent has the capacity, subject to the law of averages, to determine each machine's expected payoff date. And given its ability to transfer jackpot amounts from one machine to another, respondent has the capacity, again subject to the law of averages, to defer indefi-

nitely into the future the time at which its duty to make payment to its customers will arise.

Under these circumstances, the method of accounting that respondent favors unquestionably contains the "potential for tax avoidance" (*Thor Power Tool Co.*, 439 U.S. at 538). As the Ninth Circuit pointed out in *Nightingale*, acceptance of respondent's accounting treatment for progressive jackpots would permit casinos "to overcome the restraints of annual accounting in a perfectly legal way. They could put extra machines on the floor on the last day of the tax year with whatever initial jackpot they chose and with whatever odds they liked. Then they could take a current deduction for the full amount even though payment of the jackpots might not occur for many years" (684 F.2d at 615). There is of course no suggestion that this happened here, and it is possible that the Commissioner would have adequate tools with which to respond if it had. See Pet. App. 16a-17a; *Nightingale*, 684 F.2d at 615. But the inherent manipulability of respondent's accounting practice demonstrates its inappropriateness "in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax" (*Thor Power Tool Co.*, 439 U.S. at 544). "If management's election among [such] options were dispositive for tax purposes, a firm * * * could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay" for a particular year. "Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable." *Ibid.*

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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